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Puerto Rico

Assured's Frederico Talks Path to PREPA Plan Confirmation, Broad GO Defense

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Relevant Documents:
Press Release
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Assured Guaranty President and CEO Dominic Frederico said this morning that more work needs to be done to get to a Puerto Rico Electric Power Authority plan of adjustment while voicing confidence that steps would be taken to "force" a vote "to get over the necessary threshold or change the threshold, one of the two." Frederico also rejected the argument that Assured should pick and choose its defense of commonwealth general obligations bonds depending on its exposure to a given issuance.

"There is more work to be done to achieve a plan of adjustment based on the PREPA RSA and other credits still need to be addressed," Frederico said in a first-quarter earnings call, reiterating that Assured believes strongly in its "collateral and legal rights across all of our Puerto Rico exposures and will vigorously enforce these rights if consensual deals are not reached."

Frederico also reiterated Assured's criticism of the treatment of special revenue bonds in the Title III court and the First Circuit as a "dangerous development" for the broader municipal bond market. He also touched on positive signs for the Puerto Rico economy and the commonwealth's finances, pointing to a sustained drop in the island's unemployment rate, gains in private sector employment after Hurricane Maria, and tax collections that continue to outpace projections in fiscal 2019.

Frederico said it is "impossible to know" if the Supreme Court will agree to take up the Appointments Clause case, adding that there is still the possibility that the president will appoint, and the Senate will confirm, all or some of the existing PROMESA oversight board members.

"We believe Senate hearings would be a good place to air the differences between Congress' intended task in PROMESA and the actual performance of the board, whose actions have frequently worked against the law's express goals of respecting constitutional priorities and contractual liens," Frederico said.

GO Challenge as 'Illegal and Immoral Negotiating Ploy'

Frederico said one of the oversight board's "most troubling actions" is the attempt to have some of the commonwealth's GO bonds declared invalid and to claw back previously distributed principal and interest from bondholders on the grounds that those bonds were issued in violation of the constitutional debt limit.

He characterized the moves as a "negotiating ploy that, among other things, is intended to drive down the market value of the bonds in order to try to justify less than 100% recoveries."

"Some might argue that we should accept the invalidations because our exposure to the bonds in question is much smaller to our exposure to the unchallenged GO bonds and it could increase the likelihood of a full recovery on the rest of the GOs and perhaps better recovery on some of our other exposures," Frederico said. "That view is not only bad business but also an atrocious disregard for the rule of law. Our position is that all of the GO bonds should be provided 100% recovery, because of the constitutional requirement they must be paid before all other government expenses and there is more than adequate funds to service the debt."

Furthermore, considering the representations and disclosures the commonwealth presented when it issued the challenged bonds, and considering it already accepted and spent the proceeds, "we consider any challenge, much less invalidation, of those GO bonds illegal and immoral," Frederico said.

"It is very dangerous to allow a municipality to borrow money with all the disclosures and legal support required to bind its issuance, and then turn around and say sorry we lied and because we lied we won't pay your debt service," he added.

The Assured chief said there are multiple Supreme Court cases going back to the 19th century "that say you can't do that and for obviously good reasons."

Contagion Effect on Special Revenue Bonds

Fredrico said the commonwealth and the oversight board are also trying to persuade the courts to "reverse" the historical treatment in bankruptcy of special revenue bonds, arguing that the "entire municipal bond market understood that it is mandatory, not optional, for special revenue payments to continue uninterrupted throughout a bankruptcy."

He said the Title III court and the First Circuit rulings otherwise could carry "serious potential consequences" for the stability of the special revenue bond market.

"The contagion effect of the willingness of the commonwealth and oversight board to repay Puerto Rico's debt is already becoming evident," Frederico said, contending that ratings agencies are reexamining, and in some cases changing, revenue bond ratings based on the increased uncertainty about the security arrangements for special revenue bonds.

"More generally the market must reevaluate what full faith and credit really means and reconsider how much yield is required to compensate for political risk and the possibility that officials will be unwilling to pay the general obligations commitments made by their predecessors," Frederico said.

Assured is prepared "to take every case as far as necessary" to preserve the security arrangements and laws that underpin the municipal bond market and its legal rights under its insurance policies, according to Frederico.

PREPA's Path to Plan Confirmation

Frederico said the settlement outlined in the new RSA can be the "foundation for an effective consensual plan of adjustment" that ensures reliable power for the people of Puerto Rico, adding that Assured is committed to continuing to work cooperatively with PREPA and the other stakeholders "along the path to plan confirmation."

Asked about a "roadmap" for getting to the 67% threshold of PREPA creditors by principal amount that is needed to form an accepting class under a Title III plan of adjustment, Frederico said, "We've got something around 50% now."

"In Title III, you have to have a qualifying quorum to vote and then you need a majority of that qualifying quorum. So it's a different threshold," Frederico said, outlining the difference between Title III and Title VI voting requirements. "It's 67% percent you need as qualifying quorum to vote and then the majority of the vote of the 67% or whatever that number is above 67%. That is Title III."

The Assured chief said MBIA's National Public Finance Guarantee, the monoline with the largest exposure to PREPA bonds, at more than $1 billion in gross par outstanding, which has not signed on to the RSA, has voting rights of anywhere from 13% to 17%.

"The number continues to move. So that still leaves 83% out there, or 87% depending on your perspective, and you need 67% and we've got something around 50% now," he said.

Frederico continued: "So your guess is as good as mine. But I'm sure the government will go back and

do whatever is necessary to try to force this vote to get over the necessary threshold or change the threshold, one of the two."

Frederico was asked whether Assured has considered partnering or making some sort of acquisition with National Public Finance Guarantee to control National's holdings to help push the PREPA deal through a plan of adjustment. "Well, as you know, our goal is to combine or consolidate the entire remaining financial guarantee industry," Frederico said, adding later that Assured sees Puerto Rico "in a lot of ways as a good accerant to further opportunities relative to our consolidation goals." Frederico said Assured "looks at everybody all the time" and continues to evaluate opportunities.

"Puerto Rico tends to be one of the more contentious credits that you would look at in anyone's portfolio, so as those get resolved it simplifies the underwriting side of our acquisition opportunities, but we still have to deal with the capital side," he said. "So as we move along in Puerto Rico, and hopefully there will be more activity as we go through the year, I think it does provide a greater opportunity for Assured to continue its consolidation strategy."

"More importantly," Frederico said, "as those companies start to reach the final conclusion of whatever they are doing in their capital structure and portfolios, that becomes a good opportunity for them to either reload their business purpose and in effect go off in their new direction or liquidate the company and basically pay off their shareholders."

Assured's Recovery Potential at PREPA

Frederico touched on the economic opportunities for Assured in wrapping new PREPA bonds and how it could narrow the company's losses on that exposure relative to what is indicated in the RSA.

Frederico said Assured's ability to add value to the securitization exchange bonds it receives by potentially attaching its guarantee to them represents "an important distinction" between the monoline and other creditors in the PREPA restructuring process that could drive up its recoveries substantially.

"If we insure these bonds, we believe this could materially improve Assured's overall recovery after the transaction as well as generate new insurance premiums," said Frederico. "For that reason our economic results could differ from those reflected in the RSA." He added that by insuring the replacement bonds Assured's economic interests "would continue to remain aligned with the debtor over the long term, and we would both benefit from the debtor's improved fiscal solvency and long-term economic success."

Frederico said the way the RSA is structured, the surcharge provides a level of debt service through a fixed amount of payment into the new two-tranche bond structure. "You can think about the new bonds being issued say at 5.25% on the A bonds and like 7.5% on the B bonds," he added.

The structure and surcharges that provide "X amount" of service to the debt represent a given amount of par relative to that interest rate against the debt service payments that are being provided, said Frederico, adding that if Assured insures those bonds, the interest rate will decrease. Therefore, the principal amount of the par that will be received or will be able to be serviced through the fixed charge going through the surcharge on the electric bills would be increased.

"So it's a pickup of par that would then further improve your recovery against the bond that you are retiring and then [you also] get paid a premium relative to the insurance of the new bonds as well," he said.

Frederico said to think about what a 50-basis point improvement of the interest rate would do to a fixed-stream of cash flow relative to the new par the debt service would be able to provide. "That's how you think about the economics being improved," he said. In response to whether that means PREPA could be a single-digit relative write-off for Assured, Frederico responded, "That's a no comment."

"Remember we look at this much like COFINA in that we have the option. So it is at our option, and

we are going to look at what the government is at the time and what other covenants or requirements are going to be made through the operational independence and operational efficiency of the utility," Frederico said. "So we can always do it insured or do it uninsured. It's going to be our choice much like in COFINA where we still hold those bonds and we still have the option of insuring them to further improve the economics or not, depending on how we feel about the government and its behavior."

Puerto Rico Loss Reserves and Exposures

Assured posted net income of $54 million in the first quarter of 2019, down from $197 million in the same period a year earlier. The company said the decline in net income was mainly due to higher loss and loss adjustment expenses, fair value losses on credit derivatives and lower net earned premiums. Loss and LAE was $46 million in first quarter, compared with a benefit of $18 million a year ago. Assured said the loss and LAE was primarily related to Puerto Rico exposures, offset in part by a benefit in U.S. residential mortgage-backed securities exposures.

CFO Rob Bailenson said in this morning's earnings call that reserving for Puerto Rico exposures was influenced by special revenue rulings in the courts and the PREPA deal.

"We reacted to the First Circuit validation of Judge [Laura Taylor] Swain's ruling on special revenues," Bailenson said, pointing to assumptions that any court validation will take a longer time and that timing is therefore going out further for recoveries as well as losses.

"We adjusted our probabilities for any GO or HTA credits," Bailenson said. "On the other side, the PREPA RSA was a benefit and we adjusted our probabilities with respect to PREPA. But net-net we had an increase in reserves and loss development for Puerto Rico."

Frederico said all of the credit ratings agencies that follow Assured say its Puerto Rico exposures are manageable, adding that the monoline has "few if any other exposures in our portfolio that are truly problematic."

Assured's $4.69 billion gross par exposure to Puerto Rico government credits as of the quarter ended March 31 included $1.38 billion in commonwealth general obligation bonds; $148 million in GO-guaranteed Public Buildings Authority bonds; $874 million in Highways and Transportation Authority transportation revenue bonds; $536 million in HTA highways revenue bonds; $866 million in PREPA bonds; $349 million in Municipal Finance Agency bonds; $373 million in Puerto Rico Aqueduct and Sewer Authority bonds; $152 million in Convention Center District Authority bonds; $16 million in Puerto Rico Infrastructure Financing Authority debt; and $1 million in University of Puerto Rico debt.
